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Ongoing Compliance Updates for Investment Advisors

Compliance Review

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SEC Requires Hedge Fund Managers to Register as Investment Advisers

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Introduction

The SEC recently adopted a new rule that requires most investment advisers that manage more than $30,000,000 and manage "private funds" to register as investment advisers with the SEC by February 1, 2006. The adopting release (Advisers Act Release No. 2333 [December 2, 2004]), including the dissent by two SEC Commissioners, the proposing release (Advisers Act No. 2266 [July 20, 2004]), and public comments on the proposed rules are available at www.sec.gov/rules/final.shtml.

The registration requirement applies whether an adviser is currently unregistered or is registered as an investment adviser with a state securities authority or as a commodity trading adviser or commodity pool operator with the Commodity Futures Trading Commission. An adviser with at least $25,000,000 but less than $30,000,000 under management may (but is not required to) register with the SEC. An investment adviser with less than $25,000,000 of assets under management remains subject to state investment adviser regulation, and is prohibited from registering with the SEC, even if that adviser has 15 or more clients (exceptions from this prohibition are provided for advisers to mutual funds, pension consultants and certain other types of advisers).

Rule Amendment

Advisers Act section 203(b)(3) generally exempts an investment adviser from investment adviser registration if it (1) has had fewer than 15 clients during the preceding 12 months and (2) does not hold itself out generally to the public as an investment adviser. Advisers Act Rule 203(b)(3)-1 previously counted a hedge fund as a single client for purposes of the "fewer than 15 clients" test above. Under the amended rules, however, an adviser to a "private fund" must count each of that fund's investors as a client.

Non-U.S. advisers that manage non-U.S. private funds only are also subject to the look-through provisions (and thus may be required to register as investment advisers with the SEC), except that only U.S. investors count toward the 14-clients limit. Those advisers are exempt from many of the provisions of the Advisers Act.

Definition of "Private Fund"

A private fund is an entity that has all three of the following characteristics:

1. The entity would be an investment company under the Investment Company Act but for the exception provided from that definition by section 3(c)(1) or section 3(c)(7) of that Act. Sections 3(c)(1) and 3(c)(7) both require that a fund not make or propose to make a public offering of its securities. Section 3(c)(1) limits to 100 the number of beneficial owners of the fund's securities. Section 3(c)(7) limits sales of the fund's securities to qualified purchasers.
2. The entity permits redemptions of ownership interests in the fund within two years of purchasing those interests for all new investments on or after February 1, 2006. The SEC adopted this two-year lock-up requirement to exclude private equity and venture capital funds from the private fund definition while capturing most hedge funds within it. To avoid SEC registration, some advisers to hedge funds are now considering amending their fund documents to impose two-year lock-ups. The SEC has warned, however, that it will monitor whether the two-year lock-up requirement is effective in distinguishing hedge funds from private equity and venture capital funds.

   The new rules permit redemptions during the lock-up period due to "extraordinary" events, which include, for example, when it becomes impractical or illegal for an investor to continue to hold the interest; when redemption is necessary to avoid materially adverse tax, regulatory or ERISA consequences; when an investor dies or becomes disabled; and when key personnel of the adviser die or become disabled. An adviser may not, however, use side letters to circumvent the two-year lock-up; the SEC has stated that a hedge fund whose documents require a two-year lock-up but that enters into side letters with some investors allowing them to redeem within two years will be treated as a private fund. The new rules permit redemption during the lock-up period of interests acquired through reinvestment of distributed capital gains or income. The SEC allows an adviser to determine the age of capital contributions to its hedge fund on a first-in, first-out basis.
3. The entity's interests are offered based on the ongoing investment advisory skills, ability or expertise of the investment adviser. The SEC adopted this element to confirm the direct link between the fund manager's advisory services and investors' decisions to invest in the fund. The adopting release does not provide an example of what types of funds would be excluded by this element of the definition of private fund.

An offshore hedge fund with all three characteristics is also a private fund, and each investor in that fund (whether a U.S. or non-U.S. investor) is counted toward the adviser's 14-clients limit. Nevertheless, the rule excludes from the definition of private fund a fund that (a) has its principal office and place of business outside the U.S. and (b) makes a public offering of its securities in a country other than the U.S. and is regulated as a public investment company by that country.

Other Rule Amendments

The SEC also adopted several related Advisers Act rule amendments with varying compliance dates.

- Rule 204-2 requires an SEC-registered investment adviser to keep records that support its performance advertisements. The rule has been amended to allow an investment adviser that was exempt from SEC registration, but is now required to register under the new rule, to continue to market its performance if it retains all required records relating to periods after February 10, 2005, and any existing records demonstrating its performance prior to that date.

- Rule 204-2 now clarifies that the books and records of an SEC-registered investment adviser include the books and records of a private fund for which it (or any related person) acts as the general partner, managing member or in a comparable capacity. The records of the private fund will therefore be open to SEC inspection.
- Rule 205-3 allows an SEC-registered investment adviser to charge a performance fee or allocation only to a "qualified client" (generally, an investor with a net worth of $1,500,000, an investor with at least $750,000 under the investment adviser's management, a non-U.S. investor, a qualified purchaser for purposes of Investment Company Act section 3(c)(7), or one of several specified managers or employees of the investment adviser). To avoid requiring investors who are not qualified clients in private funds to divest their interests in those funds, Rule 205-3 now allows an investment adviser to continue to charge a performance fee or allocation to any such investor who invested in a private fund before February 10, 2005. Such investors also may make additional investments. Generally, an SEC-registered investment adviser must "look-through" any hedge fund that relies on section 3(c)(1) to determine whether each underlying investor is a qualified client. As noted in Advisers Act Release No. 2333, note 221, however, the SEC will allow an investment adviser to charge a performance fee to an offshore fund, whether or not that fund has U.S. investors.
- Schedule D of Part 1 of Form ADV now incorporates questions regarding the name, minimum investment commitment, current value of assets and other information about each private fund that an investment adviser or its related person manages. Any SEC-registered investment adviser that amends its Form ADV (and any adviser that submits its initial Form ADV in connection with an application for SEC registration) after that date must answer the new questions. Many advisers already disclose most of this information on Schedule D about U.S.-based hedge funds they manage, but an adviser must now also identify offshore private funds to which the adviser acts solely as an investment adviser (and not a general partner or manager).

Timing of Registration

Investment advisers that are required to register with the SEC under the new rules should begin that process soon. It may take at least several months to develop and implement compliance policies and procedures that meet the standards that the Advisers Act imposes on SEC-registered advisers. The SEC has routinely been approving new SEC registrations within one or two weeks, so an adviser should begin complying with all of the SEC rules when submitting the Form ADV. If hedge fund managers flood the SEC with registration applications, the SEC's turnaround time may increase, so an adviser should submit its Form ADV online by early December 2005, to ensure that the SEC declares the registration effective by the filing deadline, February 1, 2006.

SEC staff members have suggested that the SEC may adopt a new Part 2 of the Form ADV in the coming months (although there is no guarantee that it will do so). An investment adviser may want to consider this suggestion before applying for SEC registration.

Background of the New Rules

The new rules implement the SEC staff's recommendations in a September 2003 report, which was the culmination of the SEC staff investigation of hedge funds. In the proposing release, the SEC cited five principal reasons for the proposal: (1) collection of necessary data regarding private funds and their advisers; (2) deterrence and early detection of fraud; (3) ability to prevent unfit persons from managing private funds; (4) adoption of compliance controls for the protection of investors; and (5) discouraging "retailization" of hedge funds by requiring that each investor in a private fund be a qualified client.

The SEC voted three to two to adopt the rule, and the two opposing commissioners dissented in writing. Most commentators do not object to the aim of gathering more information about hedge funds. The two commissioners' dissents, objections raised by public officials (Alan Greenspan among them) and comments submitted to the SEC generally made some or all of the following objections, among others: (1) the rule will not elicit useful information; (2) evidence does not support an argument that disproportionate fraudulent activity occurs among hedge funds; (3) SEC registration is unlikely to detect or deter fraudulent activity, given the infrequency of SEC examinations; (4) the cost of additional SEC resources and expertise to regulate the additional 700 to 1,200 private fund advisers that the SEC staff has estimated will be required to register is outweighed by the unproven benefit of regulation, especially given the relative sophistication of hedge fund investors; (5) registration does not involve determination whether an investment adviser is unfit; and (6) the evidence of significant retailization is at best sparse.

Other Implications of SEC Registration

Investment advisers to private funds that are not currently SEC-registered will become subject to a number of significant requirements:

Form ADV

An adviser that is not currently required to file a Form ADV will need to complete the form and offer to distribute Part II to current and future investors in its hedge funds (and to its separate account clients). Form ADV was not designed with hedge fund advisers in mind, and many of its questions create frustrating, if not fascinating, imponderables in the hedge fund context. The SEC's proposed overhaul of Part II of Form ADV may not address the relevant issues and may result in substantially greater burden in completing and updating the form.

Custody Rule

An SEC-registered adviser must maintain each hedge fund's assets (and the assets of the adviser's other clients) with a qualified custodian and notify the fund's investors where those assets are held. Unless the hedge fund distributes annual financial statements audited in accordance with GAAP within 120 days of the end of the fund's fiscal year, an SEC-registered adviser must also arrange for the fund's account statements to be sent to the fund's investors. The new rule also allows the manager of a fund of hedge funds to distribute those audited financial statements within 180 days of the end of the fiscal year of the fund of hedge funds. State-registered or unregistered advisers that currently follow the *Bennett* and *PIMS* line of SEC no-action letters may no longer rely on those letters to avoid the custody rule if they become SEC-registered. Thus advisers that become registered in 2005 will need to prepare the 2005 audited financial statements of their hedge funds no later than April 30, 2006, to take advantage of this special rule.

Policies and Procedures

The SEC has promulgated numerous rules that require advisers to maintain specific policies and procedures regarding, among other things, prevention of insider trading, privacy, proxy voting, compliance programs and codes of ethics. Every SEC-registered investment adviser must adopt and implement policies and procedures that address, at a minimum, all of the following issues and must have a chief compliance officer who oversees those policies and procedures:

- a code of ethics designed to prevent fraud by firm personnel, which also addresses the firm's standard of business conduct, compliance with federal securities laws (which may include a fairly extensive discussion of the specific laws, rules and regulations applicable to the adviser, its employees and any funds it manages), personal securities reporting, pre-approval of certain transactions and reporting of violations of the code of ethics;

- prevention of insider trading;
- proxy voting;
- portfolio management processes, including allocation of investment opportunities among clients and consistency of portfolios with clients' investment objectives, disclosures by the adviser and applicable regulatory restrictions;
- trading practices, including procedures by which the adviser satisfies its best-execution obligation, uses client brokerage to obtain research and other services and allocates aggregated trades among clients;
- proprietary trading of the adviser and personal trading activities of supervised persons;
- the accuracy of disclosures made to investors, clients and regulatory authorities, including account statements, advertisements and published prior performance;
- safeguarding of client assets from conversion or inappropriate use by advisory personnel;
- the accurate creation of required records and their maintenance in a manner that secures them from unauthorized alteration or use and protects them from untimely destruction;
- marketing practices, including the use of solicitors;
- procedures to value client holdings and assess fees based on those valuations;
- safeguards to protect the privacy of client records and information; and
- business continuity plans to protect client interests if the adviser becomes unable to provide advisory services (for example, after a natural disaster).

Recordkeeping Requirements

SEC-registered advisers must keep myriad financial, trading, marketing, and client relations policies and procedures and general records, in most cases for at least five years and in some cases indefinitely.

SEC Examinations

SEC examinations are typically conducted by sophisticated and knowledgeable inspectors over a number of days or weeks. Based on SEC staff reports, speeches by SEC staff and SEC staff examination requests, the SEC staff is familiar with and likely to scrutinize some or all of the following hot-button issues: (1) soft dollar practices, especially those that do not meet the safe harbor provided by Exchange Act section 28(e); (2) best execution, including whether the investment adviser periodically reviews execution quality and cost and whether it documents that review; (3) trade allocation policies and practices, including whether the adviser delays allocating trades among the adviser's accounts, discriminates among clients (for example, by allocating new issues to accounts that pay the adviser a performance allocation) or misappropriates client opportunities; (4) trade error policies and practices, to ensure that advisers correct errors rapidly, do not use client assets (including soft dollars) to correct trading errors and do not discriminate among clients (for example, a client with better performance should not be allocated an error); (5) performance advertising policies, practices and documentation; and (6) valuation policies and procedures. An adviser that intends to register with the SEC should consider engaging a compliance consultant, well before its SEC registration becomes effective, to conduct a mock examination of its business to identify any areas where its existing policies and procedures fall short of SEC requirements.

Marketing and Past-Performance Disclosure

SEC-registered advisers are subject to several rules and a number of interpretations that regulate their marketing and disclosure of their past performance.

Some Significant Benefits

SEC registration does have significant benefits:

- Unlike an adviser that is not registered with the SEC or a state, an SEC-registered adviser can hold itself out to the public as an investment adviser. Public offerings of an adviser's hedge funds are still prohibited, unless the funds themselves are registered with the SEC. The SEC's adopting release clarified that the disclosure in Part 1 of the investment adviser's Form ADV that the adviser manages a private fund does not render unavailable the private placement exemption for interests in that fund.
- Some larger ERISA plans might be more likely to invest in hedge funds managed by SEC-registered or state-registered advisers, because, under certain conditions, trustees of ERISA plans may be exempt from co-fiduciary liability for acts or omissions of such advisers.
- An SEC-registered adviser may be able to exclude assets held in a client account (such as a hedge fund) from its own holdings for purposes of determining whether it has 10% beneficial ownership of an issuer's class of securities under the reporting and short swing trading provisions of Securities Exchange Act section 16.

Action Required

This memorandum provides only an overview of some of the key issues relating to the new SEC registration rule. Advisers to hedge funds should review their operations soon to determine what steps, if any, are required to comply with the new regulatory regime.

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